How Roth IRA Withdrawals Are Taxed

You may think that all withdrawals from Roth IRAs are federal-income-tax-free. Unfortunately, that's not true. Some withdrawals *are* taxable. On top of that, withdrawals before age 59-1/2 can potentially get hit with a 10% premature withdrawal penalty tax.

Here's what you need to know about Roth withdrawals and taxes.

Only Qualified Withdrawals Are Tax-Free

Roth withdrawals are tax-free if you:

- Are at least age 59-1/2 (or disabled or dead) and
- Have had at least one Roth IRA open for over five years. Then, all withdrawals from any of your Roth accounts are *qualified withdrawals*. As such, they are automatically federal-income-tax-free and penalty-tax-free.

However, you must pass both the age 59-1/2 test *and* the five-year test to be eligible for qualified withdrawals.

The five-year period for determining if you pass the five-year test begins on January 1 of the first tax year for which you make a Roth contribution. It can be a regular annual contribution or a conversion contribution.

Example 1: Earliest Date for Qualified Withdrawals

Let's say you set up your initial Roth IRA (Roth IRA-1) with a regular annual contribution that was made on April 15, 2014 for the 2013 tax year. Your five-year period began on January 1, 2013. Accordingly, anytime on or after January 1, 2018, you can take federal-income-tax-free qualified withdrawals — assuming you are at least 59-1/2 on the withdrawal date.

Now, assume you opened up your second Roth account (Roth IRA-2) in 2015 with a conversion contribution from a traditional IRA.

No matter how many Roth accounts you own, there is only one starting date for the five-year period.

Therefore, you can take federal-income-tax-free qualified withdrawals from Roth IRA-1 or Roth IRA-2 (or both) anytime on or after January 1, 2018 — assuming you are at least 59-1/2 on the withdrawal date.

Tax Reporting for Qualified Withdrawals

If you take a qualified withdrawal, you should receive a Form 1099-R from the Roth IRA trustee shortly after the end of the year when the withdrawal was taken. Box 1 of the Form 1099-R should report the total amount of withdrawals for the year. If the trustee knows the withdrawals were qualified withdrawals, box 7 of Form 1099-R should contain the letter Q, which is the qualified distribution code.

On your Form 1040 for the withdrawal year, the total amount of qualified withdrawals is reported on one line and then zero is reported on the line for taxable withdrawals because qualified withdrawals are federal-income-tax-free.

Non-Qualified Withdrawals Fall under Complex Rules

Non-qualified Roth IRA withdrawals are potentially subject to federal income tax. In addition, early non-qualified withdrawals (those taken before age 59-1/2) are potentially subject to a 10% premature withdrawal penalty tax.

Non-qualified withdrawals can occur in two basic scenarios:

- When you take withdrawals before age 59-1/2 and
- When you take withdrawals before passing the five-year test.

Scenario 1: Your withdrawals are non-qualified because you take them before age 59 1/2. Any Roth withdrawal taken before age 59 1/2 is a *non-qualified withdrawal* by definition unless a taxpayer is:

- Disabled,
- Dead, or
- Eligible for the special first-time home purchase rule explained in the right-hand box.

Non-qualified withdrawals are potentially subject to: federal income tax and a 10% premature withdrawal penalty tax. You may also owe state income tax.

As explained below, non-qualified withdrawals can potentially come from four different layers, and different tax rules apply to each layer. Complicated? You bet. All will become clear if you keep reading.

Key point: If you own several Roth IRAs, you must aggregate them and treat them as a single account for purposes of determining which layer(s) withdrawals come from and the resulting tax consequences. If your spouse owns one or more Roth IRAs, that does not affect how withdrawals from your Roth IRAs are taxed. In other words, the tax rules for Roth withdrawals are applied separately to your accounts and to your spouse's accounts.

Non-qualified withdrawals from Layer No. 1 (annual contributions). When you take non-qualified withdrawals, they are treated as coming first from Layer No. 1, which consists of the total amount of your annual Roth contributions. Withdrawals from Layer No. 1 are always federal-income-tax-free and penalty-free.

To determine how much you have in Layer No. 1, add up the total annual contributions to all Roth IRAs set up in your name and subtract any withdrawals from Layer No. 1 taken in previous years. Your tax preparer makes this calculation on Form 8606, *Nondeductible IRAs,* which is included with your Form 1040.

Withdrawals from Layer No. 2 (taxable portion of conversion contributions). After you've exhausted Layer No. 1, any additional non-qualified withdrawals are treated as coming first from Layer No. 2, which consists of the *taxable portion* of any Roth conversion contributions you've made over the years.

Conversion contributions can come from converting a traditional IRA into a Roth account or from contributing a retirement plan distribution (like from a 401(k) account) to a Roth IRA. The taxable portion of a conversion contribution is the amount of taxable income triggered by that contribution.

To determine how much you have in Layer No. 2, review your tax returns and add up all the taxable conversion contributions to all Roth IRAs set up in your name. Then subtract any withdrawals from Layer No. 2 taken in previous years. Your tax preparer makes this calculation on Form 8606, which is included with your Form 1040.

Withdrawals from Layer No. 2 are always federal-income-tax-free.

However, you'll be hit with a 10% premature withdrawal penalty tax on any amount withdrawn from Layer No. 2 within five years of the conversion contribution — unless you are eligible for one of the IRA exceptions to the penalty tax. The five-year period starts on January 1 of the year during which you made the conversion contribution. (If you made several conversion contributions, you must use the first-in-first-out (FIFO) principle to determine which conversion contribution each withdrawal comes from.)

If you owe the 10% penalty tax, there is a tax form that must be completed and included with your Form 1040.

Withdrawals from Layer No. 3 (nontaxable portion of conversion contributions). After you've exhausted Layer No. 1 and Layer No. 2, any additional non-qualified withdrawals are treated as coming first from Layer No. 3, which consists of the *nontaxable portion* of any Roth conversion contributions. The nontaxable portion of a conversion contribution is the amount of nondeductible contributions included in that contribution.

Withdrawals from Layer No. 3 are always federal-income-tax-free and penalty-tax-free.

To determine how much you have in Layer No. 3, review your tax returns and add up all the nontaxable conversion contributions to all Roth IRAs set up in your name. Then subtract any withdrawals from Layer No. 3 taken in previous years. Your tax preparer makes this calculation on Form 8606, which is included with your Form 1040.

Withdrawals from Layer No. 4 (account earnings). After you've exhausted Layers 1 through 3, any additional non-qualified withdrawals come from Layer No. 4, which consists of Roth IRA earnings.

Non-qualified withdrawals from Layer No. 4 are always 100% taxable. This calculation is made on Form 8606.

You will also be hit with a 10% premature withdrawal penalty tax on any amount withdrawn from Layer No. 4 — unless you're eligible for one of the IRA exceptions to the penalty tax.

If you owe the 10% penalty tax, your tax preparer completes another form and includes it with your Form 1040.

Example 2: Tax Impact of Early Withdrawals

In 2013, you converted a traditional IRA worth $90,000 into a Roth account. Assume the entire $90,000 was a taxable conversion contribution (Layer No. 2), because you had not made any nondeductible contributions to the traditional IRA.

In 2015, you made a $5,000 annual contribution to the same Roth IRA (Layer No. 1).

In 2017, you withdraw $105,000. At the time of the withdrawal, your Roth balance was $150,000. Assume you are under age 59 1/2.

The first $5,000 of your withdrawal is treated as coming from Layer No. 1 (annual contributions). The entire $5,000 comes out federal-income-tax-free and penalty-free.

The next $90,000 is treated as coming from Layer No. 2 (taxable conversion contributions). The entire $90,000 comes out federal-income-tax-free. However, you'll owe the 10% penalty tax on the entire

$90,000 — unless you're eligible for an exception. Why? Because you took out the $90,000 within five years of January 1, 2013 (the date you are deemed to have made the taxable conversion contribution that constitutes Layer No. 2).

The final $10,000 comes from Layer No. 4 (account earnings). The entire $10,000 must be reported as gross income on your 2017 Form 1040. Because you are under age 59 1/2, the entire $10,000 is also hit with the 10% penalty tax — unless you're eligible for an exception.

Scenario 2: Withdrawals are non-qualified because you didn't pass the five-year test. Any Roth withdrawal taken before passing the five-year test is a *non-qualified withdrawal* by definition (no exceptions).

Non-qualified withdrawals are potentially subject to: federal income tax and a 10% premature withdrawal penalty tax. You may owe state income tax too.

Scenario 2 non-qualified withdrawals are generally handled under the same four-layer system that applies to Scenario 1 non-qualified withdrawals. If you own several Roth IRAs, you must aggregate them and treat them as a single account to determine which layer(s) each non-qualified withdrawal comes from and the resulting tax consequences.

The major difference between Scenario 1 non-qualified withdrawals and Scenario 2 non-qualified withdrawals is that Scenario 2 withdrawals will never be hit with the 10% premature withdrawal penalty tax if you are age 59 1/2 or older. However, if you're younger, you will owe the penalty tax — unless you're eligible for one of the IRA exceptions.

Example 3: Tax Impact of Failing the Five-Year Test

Let's say in 2013, you converted a traditional IRA worth $90,000 into a Roth account. Assume the entire $90,000 was a taxable conversion contribution (Layer No. 2), because you had not made any nondeductible contributions to the traditional IRA.

In 2015, you made a $5,000 annual contribution to the same Roth IRA (Layer No. 1). The contribution was for your 2014 tax year.

In 2017, you withdraw $105,000. At the time of the withdrawal, your Roth balance was $150,000. Assume you're over age 59 1/2.

The first $5,000 of your withdrawal is treated as coming from Layer No. 1 (annual contributions). The entire $5,000 comes out federal-income-tax-free and penalty-free.

The next $90,000 is treated as coming from Layer No. 2 (taxable conversion contributions). The entire $90,000 comes out federal-income-tax-free. You don't owe the 10% penalty tax because you are over age 59 1/2.

The final $10,000 comes from Layer No. 4 (account earnings). The entire $10,000 must be reported as gross income on your 2017 Form 1040. You don't owe the 10% penalty tax because you're over age 59 1/2.

Tax Reporting for Non-Qualified Withdrawals

If you take a non-qualified withdrawal, you should receive a Form 1099-R from the Roth IRA trustee shortly after the end of the year when the withdrawal was taken. Box 1 of the Form 1099-R should report the total withdrawals for the year. If the trustee thinks the withdrawals are non-qualified and subject to the 10 percent penalty tax, box 7 of Form 1099-R will contain the letter J (the early distribution code). If the trustee knows a taxpayer doesn't owe the 10% penalty tax because he or she is age 59 1/2 or older, disabled, or dead, box 7 of Form 1099-R will contain the letter T (the code for an exception to the 10% penalty tax).

Form 1099-R is used by your tax preparer to complete your Form 1040. As explained above, Form 8606 is completed by your return preparer to determine if any of your non-qualified withdrawals are taxable. If you owe the 10% penalty tax, another form is completed and included with your return.

Special Home Buyer Rule for Those Under Age 59-1/2

After you've passed the five-year test described in this article, a special rule allows federal-income-tax-free and penalty-free Roth withdrawals for some home buyers. To qualify, you must spend the money within 120 days to pay qualified principal residence acquisition costs. However, there is a $10,000 lifetime limit on this special rule.

To the extent the special rule applies to a withdrawal, the eligible amount is treated as a qualified withdrawal. In other words, it is free from federal income tax and penalties.

The principal residence can be purchased by:

- You as the account owner;
- Your spouse;
- Your child, grandchild, or grandparent; or
- Your spouse's child, grandchild, or grandparent.

The home buyer (and the buyer's spouse if the buyer is married) must not have owned a principal residence within the two-year period that ends on the acquisition date. Qualified acquisition costs are defined as those spent to acquire, construct, or reconstruct a principal residence — including closing costs.

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